1940

Economic Conditions
Governmental Finance
United States Securities

New York, August, 1940

General Business Conditions

THE outstanding fact of the business situation is that the United States is starting out to build a vast new industry. During the past ten years many of our people, disappointed and disheartened by the failure of the country to resume the steady growth of production and trade that had been its characteristic for over a hundred years up to 1929, have searched eagerly for signs of some new industry capable of absorbing large amounts of capital and labor. It appears now that such an industry is in the making—the manufacture of armaments.

It is a tragic circumstance that this long-hoped-for stimulus should come from the manufacture of weapons of war. In the past our great industrial forward movements, such as the building of the railroads and of the automobile industry, have been in furtherance of the peaceful arts, creating new usable goods and facilities that have added to the wealth of the country and given new satisfactions and conveniences to the people. Now, however, we are embarked upon the building of a great establishment to turn out battleships, airplanes, tanks and other war equipment which, though necessary for protection, add neither to real wealth nor the fulfillment of human wants, laying instead a continuing burden upon the productive powers of the nation.

Nevertheless, deplorable as is the diversion of labor and capital to non-productive uses, it must be recognized that the expenditure of vast sums upon armament can create a high speed turnover in business, make jobs and give the appearance of prosperity while the spending lasts. With so much work to be done, the outlook ought to be for a high level of production, trade and employment for a long time to come. The chief questions that now arise concerning the trend are (1) as to how long it will take to get the defense program really under way, and (2) whether our national policies towards industry will be such as to encourage an increase in the aggregate output to take care of national defense, or whether, as a result of unwise and smothering restrictions upon enterprise, we achieve only a reshuffling of the economy with a squeezing of national defense needs out of current production and the standard of living. For the longer future there is of course the additional question whether the defense effort will eventually lead to economic disturbances of the inflationary or other sorts.

Conditions in the Industries

Meantime, business generally continued active in July, with no marked indications of change of trend. Following the rapid upturn that had taken place since April, an easing up in the placement of orders and pressure for deliveries has been noted here and there which may possibly portend a flattening out of the production curve for the time being. With the publicity that has been given to the huge purchase program of the United States Government, business men have been prompted to do a considerable amount of anticipatory buying to make sure of supplies. This naturally induces more caution as to further commitments. Moreover, business men are not unmindful of the possibility of a setback in the event of an early termination of the war in Europe, while the prospect of additional taxation on top of the already extremely heavy tax burden is giving increasing concern.

Airplane and machine tool manufacturers and shipbuilding yards, of course, are mostly booked up for months to come. In the steel industry an expansion of output of about 25 per cent has occurred since May and operations are now at above 90 per cent of capacity —a very high rate for this season of the year. While some of this output is evidently for inventory purposes, the outlook for major consumers of steel is sufficiently good to warrant the belief that the rate of operation may be maintained at relatively high levels during the balance of the year. At the quarterly meeting of the Bethlehem Steel Corporation on July 26, it was stated that commercial orders for steel were at the rate of 130 per cent of capacity, and that unfilled orders, including recently placed government contracts for naval construction,

had reached a new peacetime record of $480,-000,000. Evidently some companies have experienced a tapering off in new business during the past month, but in view of the current high backlogs and the government defense business ahead, no significant downturn seems to be expected, save possibly in case of a sudden end to hostilities abroad.

Automobile sales have held up exceptionally well for the season and, together with the seasonal decline of production preparatory to new models, have resulted in rapid progress in cleaning up the dealers' heavy stocks.

Defense Projects Lift Construction

Building construction likewise continues to give a good account of itself. Despite frequently expressed fears that war uncertainties would check residential building, the Dodge totals for this class of awards in June and the first half of July were well up to the best for the year and substantially greater than in the corresponding period of last year, while F.H.A. reports on mortgages accepted for insurance continue to run at record levels. In the field of heavy construction, defense projects are commencing to cut an important figure, lifting the Engineering News-Record tabulations of contract awards to new high levels in July.

A large volume of business is pressing upon the electrical equipment manufacturers, not only in the consumer goods types such as refrigerators, ranges and vacuum cleaners, but also in the heavier lines. Many utility companies, anticipating not only difficulty in obtaining generating equipment at a later date, but also greater consumption of electric power under the armament program, have stepped up their building plans. Both General Electric and Westinghouse report their unfilled order totals the largest on record in peacetime.

Maintenance expenditures by the larger railroads increased moderately during the first five months of 1940, and indications are that such expenditures will be as high or higher during the rest of the year. Equipment orders, principally for cars and engines, have thus far this year run well ahead of a year ago; and although considerable equipment was ordered last Fall and no shortage of rolling stock seems imminent, nevertheless further purchases are likely as a precautionary measure.

In the non-ferrous metals, price weakness in copper early in the month disappeared during the final week on renewed fabricator buying which cleaned up the market of prompt metal. Domestic consumption of copper continues active, with a normal three months' supply in producers' hands, and fabricators' shipments of finished products rising and fully a third above a year ago. Both lead and zinc prices have held firm, with lead stocks in producers' hands the lowest in ten years. There has been a strong demand for zinc, partly because the domestic galvanizing industry is very active and partly because a heavy export movement—the largest since 1929— has developed to South American and Oriental markets which were formerly supplied by Belgian refineries. In the case of tin, the announcement that the newly formed Metals Reserve Co. would acquire a year's supply for defense purposes at 50 cents a pound, c.i.f. New York, through regular trade channels during the next twelve months has placed a floor under the market and permitted producers, in effect, to remove all restrictions on production.

Summer Wholesale Buying Good

Turning to the distributive trades and lighter industries, — Summer wholesale markets have been well attended and orders placed for the Fall retail trade generally as good as, or better than, a year ago. Sentiment among buyers appeared conservatively optimistic for Fall business, with merchants from industrial areas where employment is forging ahead noticeably more liberal in the placing of orders than those from agricultural sections. Sales to the public by leading department stores, chain organizations and mail order houses continued to run above a year ago by a good margin.

In textiles, slow sales during July, coupled with relatively high production, caused substantial inroads to be made on cotton mill backlogs so that while mills still have sufficient orders from the June buying wave to sustain operations well into August, there will be need for additional business before Labor Day. In woolens, uncertainty over foreign wool prices has been a restraining influence so that the general run of business has been disappointing. However, the placing of large government orders for army cloths and blankets in June has more than made up for slowness in other directions, and mill operations are up rather sharply from the Spring low point. To an increasing extent, mills are becoming dependent upon government business.

The rayon market, on the other hand, has continued active. Producers have operated virtually at capacity since the beginning of the year and their deliveries have broken all records. In sharp contrast to rayon, silk consumption has recently dropped to the lowest level in twenty years and silk prices have had to be supported by Japanese Government buying. The present situation is an aftermath of the excessive speculation in the silk market last year which upset the equilibrium between supply and demand and led to the present heavy supplies in Japan.

June Exports Higher

Despite the surrender of France in mid-June and the closing of the Mediterranean area, June merchandise exports of $350,000,000 were about $25,000,000 above both April and May and $114,000,000 greater than in June last

year. With the imports maintained around the $200,000,000 level, the export balance for June was $139,000,000 and $774,000,000, for the first six months of 1940, highest for any similar period since 1921.

The gain in exports was primarily due to the mounting shipments of war materials which in June were the heaviest since the outbreak of the war, firearms and explosives alone increasing about fifteen-fold to $26,000,000. Altogether our shipments of aircraft, nonferrous metals, iron and steel mill products, metal working machinery and industrial chemicals, including explosives, reached in June some $145,000,000, or over 40 per cent of our total exports. The shift to war material exports was made more pronounced by the decline in the June exports of motor vehicles, lumber and farm products, the latter dropping, partly as a result of seasonal influences, to $31,000,000, a new low level since the start of the war.

The shift to war supplies also influenced the geographical distribution of exports. Sales to both Great Britain and to Canada reached a new war peak. Practically half of our exports are now consigned to the British Empire compared with about 41 per cent last year. Our exports to France, which still amounted to $45,000,000 in June, are likely to disappear. The European Continent—outside of France and Russia—took in June only about $14,000,000 of our exports compared with an average of $61,000,000 for the first three months of 1940. On the other hand, exports to South American countries, despite their difficulties in securing the means of payment, rose in June to the highest level for the war period. Trade with Japan improved after a decline in preceding months, but may be adversely affected in the future by the licensing system for oil and scrap steel exports, announced by the President last month.

The Situation in Agriculture

Abundant rains since early Spring brought about a remarkable recovery of Winter crops, planted under rather severe drought conditions last Fall. The progress of Spring crops until recently has been also the best in many years. The latest government estimate, based on July 1 conditions, indicated that despite reduction in acreage the 1940 crops would be better than average and only slightly below last year's harvest. Consequently, instead of having to fall back on our heavy surpluses built up in the past three seasons, as seemed likely only a few months ago, it now appears that we will add further to these surpluses in several important commodities, particularly in cotton, tobacco and pork products, whose export prospects have been seriously affected by the war.

Due to excellent growing conditions since April, the latest report of Crop Reporting Board raised the estimate of Winter wheat to 524,000,000 bushels, or over 30 per cent more than was expected last December. With a carryover of old crop wheat of 280,000,000 bushels and the Spring crop estimated at 205,000,000 bushels, our total wheat supply for the 1940-41 season should be about the same as last year, or over 1,000,000,000 bushels, while export prospects are less favorable.

On the basis of the government July estimate, feedstuffs should be ample, with requirements smaller in view of the 10 per cent reduction in this year's pig crops and a similar decrease in the number of young chickens on farms. If the forecast materializes, we should have an average corn crop, which, together with a record carryover from the last crop of some 600,000,000 bushels, should insure an abundant supply of corn despite damage resulting from the recent heat wave.

The present corn crop is being grown on the smallest acreage in 46 years, reflecting the AAA curtailment program. Much of the acreage so released has been planted in barley, oats and soybeans so that total supplies of feedstuffs, including carryovers, will approximate 116,000,000 tons as compared with 117,000,000 tons in the past season, which was the largest since 1932.

Despite the large corn supply, hog breeding was discouraged last season because of relatively high corn prices. Bolstered up by the government policy of withdrawing corn from the market, corn prices failed to adjust themselves to hog prices, which, under the influence of heavy slaughter and the loss of export markets, dropped in the past season to the lowest level in about six years. Hog prices, however, recovered about 20 per cent last month as a consequence of the seasonal decline in slaughter.

Estimated cash income of farmers improved nearly $300,000,000 or 8 per cent during the first half of 1940 as compared with the same period in 1939. Higher incomes resulted from the marketing of one of the largest crops on record and at generally higher prices due to a more extensive participation of farmers in the government loan program. Between the further expansion of the domestic consumers' demand as the defense program gets under way, and a continuation of government supporting measures, farm income is expected to be sustained during the remainder of the year at above the same period of 1939.

Money and Banking

During June gold imports reached a record total of $1,164,000,000, equal to about four-fifths of the estimated gold output of the entire world for one year. Not all of this metal, of course, was sold to the United States Treasury, some of it going into the foreign earmarked stock held here for safekeeping and for future sale to our Treasury if and as occasion requires.

Even so, the gold stocks held by the Treasury increased no less than $750,000,000 during June and $480,000,000 more during the first 27 days of July to a new all-time high of $20,443,000,000.

Reflecting the gold inflow, member bank excess reserves rose to a new peak of $6,880,000,000 on July 17, and would have gone still higher but for the cash subscriptions to the Treasury's new bond issue which had the effect of temporarily shifting funds from the market to the Reserve Banks. While financing by Treasury agencies is expected to absorb a further amount of money market cash in the near future, eventually these funds will be returned to the market, causing a corresponding recovery in excess reserves at that time.

The Treasury financing referred to above took the form of 2¼ per cent bonds of 1956 (callable in 1954), issued in the amount of $671,319,850, and was the first direct Treasury offering for other than refunding purposes since last December. The offering was favorably received, and at this writing is quoted around 102½.

At the weekly reporting member banks, holdings of Government securities expanded sharply to a new high record, due partly to purchases of the new Treasury 2¼s. Thus far there has been little evidence that steps toward national defense are causing an increase in the demand for bank loans. Business loans of the reporting banks, after rising slowly for a seven weeks' period, were down slightly in the latest report (July 24). Reflecting both the expansion of bank assets and gold imports, deposits rose further to new high levels.

The market for outstanding bonds was steady but extremely dull during the month. Chief activity was in new financing which included some $238,000,000 of corporate securities, principally refunding, and about $80,000,000 of new municipal flotations. Not included in the foregoing was a loan of $92,000,000 by the R.F.C. to the Wright Aeronautical Corporation for plant expansion purposes. The reception accorded new issues was mixed, depending on quality and pricing.

The Half Year's Profits

Reports issued during the past month by leading corporations show a sharp increase in earnings in most lines of business during the first half year over the earnings of a year ago, accompanying the increase in general business activity. A tabulation of the published statements of 400 industrial corporations gives combined net profits, after taxes and less deficits, of approximately $649,000,000 in the first half of 1940, which compares with $409,000,000 for the same companies in the corresponding period of 1939 and represents a gain of 59 per cent. These companies had an aggregate capital and surplus of $11,896,000,000 at the beginning of this year, upon which the six months' profits were at an annual rate of 10.9 per cent, against a rate of 7.0 per cent upon a slightly smaller net worth a year ago.

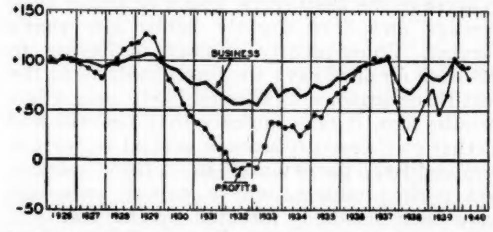
Separate figures available by quarters for 325 of these companies show combined net profits of $296,000,000 for the second quarter, which compares with $315,000,000 in the preceding quarter and with $197,000,000 in the second quarter of 1939. In most years, there has been a substantial increase in profits from the first to the second quarters, but this year the increases were limited and numerous companies reported decreases instead.

One reason for the less-than-seasonal gain was the relatively high level of profits reached in the first quarter, when production was high (though declining) and sales were swelled by shipments from the heavy production in December. The low point of production occurred in April, but the rapid expansion in May and June was not sufficient to carry second quarter profits ahead for the usual seasonal gain.

A second adverse influence upon second quarter profits was the Revenue Act of 1940, passed by Congress in June but made retroactive to January 1, 1940. This Act raised the effective rate of the federal corporate income tax from 18 per cent to 20.9 per cent, or by about one-sixth. The new rates have prompted most corporations not only to set up increased reserves for taxes out of their second quarter earnings, but also to increase the tax reserves set up at the old rates against first quarter earnings; and in most cases these adjustments were charged against second quarter operations. In a few cases where companies have made no attempt in their interim statements to compute the amount of federal income and excess profit taxes payable, the reported "net profit" is before allowance for such taxes, which has the effect of overstating real earnings.

Other factors which, although not applying to business generally, affected to an important extent the second quarter profits of some companies, were the reduction or suspension of income from foreign subsidiaries, branches or agencies, and the decline in prices of certain commodities (food, textile, metal, etc.), which necessitated inventory adjustments.

The longer term trend of profits is shown on the diagram given below by an index based



Quarterly Index of Industrial Corporation Profits and the Annalist Index of Business Activity. 1926 = 100

upon rate of return on net worth of 200 large industrial corporations and adjusted for seasonal variation. In comparing the trend of this series with the accompanying table and comments, it should be noted that the index refers only to industrial corporations, and does not include railroads or utilities.

While the preliminary profit index for the second quarter shows a continuation of the decline from the recent peak reached in the final quarter of 1939, the level is otherwise the highest since the third quarter of 1937.

Trends in Major Industries

In the accompanying table, the combined net profits of major industrial groups are given for the first half year 1939-40, together with net worth and annual rate of return. As pointed out heretofore, the promptly published figures of leading corporations are useful as indicating the trend of profits, but do not provide an accurate measure of average rate of earnings for business as a whole. The latter can be found only in the official Statistics of Income, condensed summaries of which have been given in the Bank Letter from time to time.*

*See current issue, page 92, and November 1939, page 128, for "all corporations"; and November 1939, page 128, for "all manufacturing corporations".

An examination of the comparative profits for the first half year shows the sharpest gains to have been made in the industries which last year were still relatively depressed. It is noteworthy also that the gains are not confined to the companies producing war materials for the British Government or for our own expanding national defense program, but instead are widely distributed among the different major industries.

An outstanding gain was registered by the steel companies, whose high rate of operations permitted a lowering of unit costs and a widening of profit margins, despite the temporary reduction in price on certain products. Manufacturers of machinery, tools and various types of equipment have continued to operate at a high rate, and in some cases have made a larger profit in the first six months of 1940 than in the entire year 1939. The automobile industry set a high record in production during the first half year, while auto equipment and accessory plants have been busy on orders from the aircraft industry also. Chemical companies have had heavy demand for their products from the steel and other active industries, but in some instances the increased defense taxes have cut into the margins of net profit.

PROFITS OF LEADING CORPORATIONS FOR THE HALF YEAR

Net Profits Are as Reported, After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends.—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industrial Groups	Net Profits Half Year 1939	Net Profits Half Year 1940	Per Cent Change†	Net Worth January 1 1939	Net Worth January 1 1940	Annual Rate of Return % 1939	Annual Rate of Return % 1940
6	Baking	$ 8,981	$ 8,215	— 8.5	$211,655	$208,255	8.5	7.9
19	Food products — misc.	34,021	35,757	+ 5.1	607,688	614,329	11.2	11.6
7	Beverages	6,866	8,344	+21.5	116,655	122,704	11.8	13.6
14	Textiles and apparel	5,048	7,638	+51.3	134,764	145,051	7.5	10.5
4	Shoes and leather	3,284	2,989	— 9.0	118,015	118,856	5.6	5.0
7	Wood products	144	1,770	+	70,072	64,208	0.4	5.5
14	Paper products	3,428	8,152	+	151,359	160,883	4.5	10.1
26	Chemicals, drugs, etc.	64,855	89,987	+38.8	1,181,829	1,223,575	11.0	14.7
12	Petroleum products	19,505	60,298	+	1,394,724	1,419,065	2.8	8.5
15	Stone, clay and glass	12,292	16,710	+35.9	314,662	317,894	7.8	10.5
1	Iron and steel — U. S. Steel	1,970	36,315	+	1,298,907	1,314,807	0.3	5.5
29	Iron and steel — other	12,766	44,887	+	1,423,434	1,456,323	1.8	6.2
12	Building equipment	2,641	7,400	+	216,859	209,185	2.4	7.1
17	Electrical equipment	26,662	44,450	+66.7	614,834	645,533	8.7	13.8
12	Hardware, tools, etc.	3,315	5,930	+78.9	95,259	98,881	7.0	12.0
10	Household equipment	2,898	3,459	+19.4	55,797	57,167	10.4	12.1
31	Machinery	6,876	16,420	+	272,345	266,511	5.0	12.3
10	Office equipment	8,339	10,731	+28.7	168,918	171,344	9.9	12.5
10	Railway equipment	1,667	9,869	+	181,918	173,979	1.8	11.3
1	Automobile — General Motors	100,993	113,575	+12.5	1,027,817	1,053,560	19.7	21.6
10	Automobile — other	24,342	33,362	+37.1	284,426	300,254	17.1	22.2
22	Auto equipment	10,849	17,648	+62.7	159,396	170,175	13.6	20.7
28	Metal products — misc.	8,971	18,644	+	171,638	186,521	10.5	20.0
17	Misc. manufacturing	8,476	7,246	—14.5	202,432	206,491	8.4	7.0
334	Total manufacturing	379,189	609,796	+60.8	10,475,403	10,705,551	7.2	11.4
10	Coal mining	D-3,020*	D-430*	......	215,156	201,314	....	....
10	Metal mining	8,997*	12,745*	+41.7	288,833	292,479	6.2	8.7
9	Mining, quarrying — misc.	6,488*	8,043*	+24.0	109,517	110,282	11.8	14.6
21	Trade (wholesale and retail)	6,979	7,739	+10.9	235,629	234,672	5.9	6.6
16	Service and construction	10,490	11,035	+ 5.2	341,532	351,835	6.1	6.3
400	Total	$409,123	$648,928	+58.6	$11,666,070	$11,896,133	7.0	10.9

D-Deficit. *Before certain charges. †Increases or decreases of more than 100 per cent not computed.

Some of the paper companies, as a result of the heavy demand for the various paper and paperboard products, combined with a restricted supply situation created by the war, have reported the highest rate of profit in several years. The same is true of certain lumber products. Among the few textile companies which issue quarterly reports, the outstanding gains were in rayon, the production of which in 1939 was three times that of 1929, yet continues to grow at a rapid rate.

In the baking and some of the other food industries, on the other hand, the weakness in commodity prices mentioned above has slowed down sales and held down earnings for the first half year, while the unseasonable weather during Spring and early Summer hurt the ice cream and dairy products industry. Petroleum refining companies, most of which made sharp gains during the first quarter as a result of the heavy demand for products (including fuel oil), have been affected by curtailed export sales, accumulation of inventories of refined products and a weakening of prices in some sections, combined with the increased federal excise and income taxes.

Change in Half Year's Sales

Sales figures issued by 40 large manufacturing companies aggregate $2,757,000,000 for the first half year, and represent a gain of approximately 20 per cent over the $2,300,000,000 total for the same companies in the first half of last year. As indicated by the accompanying list, the changes among individual companies were, as usual, highly uneven.

% Change in Half Year's Sales, 1939-1940

Manufacturing		Retail Trade	
Air Reduction Co.	+12.8	American Stores Co.	+13.9
Allis-Chalmers Mfg. Co.	+13.9	Barker Bros. Corp.	+ 0.4
Amer. Steel Foundries	+63.4	Bond Stores	+31.6
Baldwin Loco. Wks.	+97.2	Consol. Retail Stores	+ 4.0
Beatrice Creamery Co.	+15.2	Crown Drug Co.	+ 6.8
Caterpillar Tractor Co.	+17.5	Davidson Brothers	+23.3
Chrysler Corporation	+23.8	Edison Bros. Stores	+ 4.4
Cluett, Peabody & Co.	+ 7.2	W. T. Grant Co.	+ 4.0
Container Corporation	+38.7	H. L. Green Co.	+ 3.7
Continental Baking Co.	+ 0.6	Interstate Dept. Stores	+ 3.2
Continental Steel Corp.	— 0.3	Jewel Tea Co.	+13.4
Crown Cork & Seal Co.	+22.0	G. R. Kinney & Co.	— 2.1
Devoe & Raynolds Co.	+14.4	S. S. Kresge Co.	+ 3.1
E. I. du Pont & Co.	+19.5	S. H. Kress & Co.	+ 4.5
Fairbanks, Morse & Co.	+ 6.8	Kroger Groc. & Bak.	+ 7.6
Florence Stove Co.	+15.7	Lane Bryant, Inc.	+ 0.2
General Electric Co.	+30.0	Lerner Stores Corp.	+ 4.6
General Foods Corp.	+ 4.7	Lincoln Stores	+ 3.7
General Motors Corp.	+24.4	McCrory Stores Corp.	+ 6.2
General Time Instrumts.	+26.2	McLellan Stores Corp.	+ 2.8
B. F. Goodrich Co.	+ 2.1	Melville Shoe Corp.	+ 4.4
Hazel-Atlas Glass Co.	+ 7.9	Montgomery Ward	+11.2
Hercules Powder Co.	+37.4	G. C. Murphy Co.	+12.9
International Shoe Co.	+ 4.4	National Tea Co.	+12.3
Johns-Manville Corp.	+18.0	Neisner Bros., Inc.	+ 0.7
Kimberly-Clark Corp.	+ 7.8	J. J. Newberry Co.	+ 5.5
Mead Corporation	+20.5	David Pender Grocery	+14.2
Monsanto Chemical Co.	+ 3.9	J. C. Penney Co.	+ 8.3
Natl. Cash Register Co.	— 0.3	Peoples Drug Stores	+ 2.9
Otis Elevator Co.	+18.8	Reliable Stores Corp.	+19.6
Phillips Pet. Co.	+ 7.4	Safeway Stores	+ 5.6
Scott Paper Co.	+16.3	Schiff Company	+ 3.4
Sharon Steel Corp.	+39.8	Sears, Roebuck & Co.	+11.2
Shell Union Oil Co.	+10.8	Spiegel, Inc.	+ 6.0
Simmons Company	+ 5.1	Sterchi Brothers	+ 7.2
Studebaker Corp.	+12.4	Union Premier Food	+29.5
Sun Oil Co.	+27.3	Un. Cigar-Whelan Stores	— 2.0
Tide Water Assd. Oil Co.	+10.1	Walgreen Company	+ 5.4
Wesson Oil & Snowdrift	+ 0.1	Western Auto Supply	+19.4
White Motor Co.	+66.7	F. W. Woolworth Co.	+ 5.2

Sales of the 40 large chain store, department store and mail order organizations, whose volume of business tends to fluctuate much less widely than that of manufacturers, increased from $1,674,000,000 in the first half year 1939 to $1,810,000,000 in the first half of this year, or by 8 per cent.

Railroad and Utility Earnings

Railroad freight and passenger traffic has shown gains over last year in each of the first six months, with total operating revenues for the half year up by about 11 per cent. Total operating expenses increased by only 7 per cent, and the balance of net operating income (before fixed charges) rose by 46 per cent. It is estimated that, for the class 1 systems as a whole, there was a net profit after interest charges in June, and a small deficit for the six months' period, in contrast with a deficit of $92,000,000 a year ago. The high level of carloadings in July indicates a continued improvement in earnings for that month.

Considerable progress has been made this year toward reorganization of the numerous systems that are being operated by receivers or trustees, and certain roads are expected to complete their reorganization and be restored to solvency by the end of the year, with the elimination of their defaulted securities from the market and the issuance of new securities in exchange.

A group of 25 large public utility systems supplying electric light and power, gas and other services, and reporting for the twelve months ended June 30, showed an increase of about 5 per cent in total operating revenues over the twelve months of the year previous. Because of the increase in operating expenses and taxes, however, the increase in net income was only 3 per cent.

The American Telephone & Telegraph Company and its principal telephone subsidiaries, reporting for the twelve months ended May 31, had an increase in total operating revenues of 6 per cent. Despite an increase in operating expenses and taxes, the net income rose by 20 per cent, due in part to increased income from investments in non-telephone subsidiaries.

Defense Expenditures and Taxation

In the President's regular budget message last January, military and naval expenditures for 1941 were estimated at $1,840,000,000. This total was looked upon then as an unusually heavy item for defense, and was in fact the largest for any year since 1920. However, as alarm developed over the European situation, the President submitted supplementary requests for $1,182,000,000 on May 16 and $1,-

277,000,000 on May 31. Actually, Congress went well beyond these figures, with the result that by the end of June total defense appropriations, including contract authorizations approved this session and available for the fiscal year 1941, had risen to $5,084,000,000.

To this total must now be added the $4,848,000,000 requested by the President July 10 for defense purposes, which would bring total funds available for such purposes to almost $10,000,000,000. This total includes only relatively small appropriations for the first year of the "Two Ocean Navy" program, authorized by Congress in July, calling for a 70 per cent expansion in naval tonnage over the next six years, the direct cost of which has been estimated by the Navy Department at more than $4,000,000,000. These figures, of course, are in addition to the ordinary running expenses of the Government, and such extraordinary expenditures as those by the WPA, PWA, AAA, or other agencies of the Government, which, together with defense expenditures, resulted in a deficit for the year ended June 30, 1940 of $3,612,000,000.

Ways and Means of Meeting the Estimates

The series of Treasury deficits resulting from business depression after 1929, forced a general increase of taxation. The Hoover Administration took the first steps toward increasing taxes and the Roosevelt administrations have been seeking more revenues ever since. Practically all of the reductions in income taxes that had been made between the end of the war and 1929 were restored, and excise taxes were expanded in like manner.

As soon as the defense program was started, work began on a new revenue bill, which became a law in June and was reviewed in these columns last month. It is estimated to yield approximately a billion dollars a year, which even yet remains an important sum. The largest item of increase will come from lowering income exemptions in both married and single groups and increasing rates. The yield from excise taxes will be increased by adding new subjects and raising rates.

On July 1, the President sent another message, proposing a "steeply graduated excess profits tax to be applied to all individuals and corporate organizations without discrimination."

When this message came Treasury officials, Army and Navy officials and the Defense Advisory Commission were in a state of perplexity on account of the Vinson-Trammell Act, which had become a law but shortly before. The act limits profits on airplane or shipbuilding contracts to 8 per cent under competitive bidding or 7 per cent under "cost-plus" arrangements. Contractors were urging that while these rates might be ample if account were taken of all costs and if the business could be counted upon to continue until new machinery and plants were fully amortized, actually neither of these conditions was fulfilled. In determining costs incurred on government contracts, certain normal items of expense are not allowable deductions,—for example, federal and state income taxes, interest on working capital loans, losses in connection with research and development, and other items. Thus, in fact, the maximum possible profit would fall considerably lower; and of course even this is not guaranteed. Considering all the normal hazards of doing business, plus uncertainty as to the duration of the present demand, contractors were naturally hesitant about building special plants for war purposes on these terms.

One of the most vexing phases of this problem has been the rate at which manufacturers taking war orders would be permitted to write off new plant and equipment in computing taxes. At present the rate is limited to 10 per cent annually which means that it will take ten years to write off plant and machinery that may become virtually worthless much sooner. New capital is not readily attracted for investment when current profits are so heavily taxed as to provide little reserve against potential losses. While it is true that under the present law the Treasury has authority to allow greater than the usual charge-off on proof that the facilities have in fact become worthless, business men are reluctant to take chances on future rulings.

Thus, much business has been held up and valuable time lost. However, on July 10 an announcement was made at the White House which alters the outlook considerably. The statement said that after a conference by the President with representatives of the Treasury, the Federal Loan Administrator (Mr. Jesse Jones), the National Advisory Defense Commissioner (Mr. William Knudsen), and Congressional leaders —

> **It was unanimously agreed by those attending that the excess profits tax bill soon to be introduced will incorporate a provision for amortization, over a five-year period, of additional facilities, including both plant and equipment, certified as immediately necessary for national defense purposes by the Army and Navy and Advisory Commission of the National Defense Council.**
>
> **It was also unanimously agreed that the proposed excess profits tax bill, which will apply generally to all industries, will be substituted for the excess profits provisions of the Vinson-Trammell act which now apply only to Army and Navy aircraft and naval vessels.**

Encouraging as this is, it is still too soon to say what the effects will be. Whether a five-year amortization period will be regarded by manufacturers as adequate protection remains to be seen. The National Defense Advisory Commission is reported to have recommended four years, and perhaps even a shorter period might be desirable in some cases. Moreover, the new proposals still have to be approved by Congress, and, finally, there is the prospect of new taxes looming ahead.

The Excess Profits Tax As Proposed

It is this last which is giving business men particular concern. Their anxiety, however, does not arise from the expectation of making large profits out of national defense, but rather from a wish to avoid losses. They know, too, that if the risks of investment are made too great, new capital will be difficult to obtain through the normal channels; hence not only impeding the development needed to maintain employment and increase the national income out of which additional taxes might flow, but also retarding the now vitally necessary expansion of the defense industries. Some of the tax proposals which have gained a hearing in Congress have been so extreme that business men have been greatly disturbed and hardly know what to expect. Yet they must know what they are up against, if they are to make plans for the future.

It is generally assumed that the excess profits tax recommended by the President would apply chiefly to corporations, and would provide a sharply rising scale of rates to the incomes of corporations whose profits might be swelled as a result of the defense program or by this country's actual entry into war. The meaning of that part of the President's message touching individuals was not quite clear. It would be extraordinary to subject individuals to a steeply graduated excess profits tax in addition to the already steeply graded income surtaxes, which in the upper brackets leave very little income to be taxed. Recent reports from the discussions in Congress appear to indicate that this difficulty is being recognized, as it was in 1918, when a similar tax imposed in 1917 was repealed.

The excess profits tax proposal, as applied to corporations, calls for a new tax quite different from the present excess profits tax, but corresponding to the war and excess profits taxes in force during 1917-21. During those years, in addition to income tax, corporations were subject to a capital stock tax on the current value of their capital stock, and to a war excess profits tax based on "invested capital." Generally speaking, the "invested capital" had no relation to current value, but was strictly limited to the capital contributed by the shareholders plus earnings retained in the business. Earnings in excess of 8 per cent on such "invested capital" were considered excess profits and were taxed at graduated rates ranging from 20 to 65 per cent. The latter tax was repealed in 1921, and the capital stock tax in 1926.

In 1933, the capital stock tax was reenacted; but instead of basing it upon the actual current value of the capital stock, corporations were allowed to declare whatever value they pleased, without regard to current value, under penalty of paying an excess profits tax, at comparatively low rates, if their earnings exceeded 12½ per cent (later 10) of the value so declared, with annual adjustments. Naturally corporations tended to declare high values for their stock so as to minimize the excess profits tax.

Whether the present capital stock-excess profits combination taxes are retained or not, the proposal calls for a new graduated tax on earnings in excess of a normal standard. Such normal standard will probably be determined by the "invested capital" method used under the earlier laws, or by taking the average earnings for some period of years prior to 1940, or by a combination of those two methods.

Present and War-time Corporate Taxes Compared

The proposal for a new excess profits tax comes at a time when corporate taxes and corporate income generally are far different than when the war excess profits tax was originally imposed in October 1917, six months after our entry into the war. At that time, corporate incomes were relatively high, the normal federal income taxes were relatively low, and all other taxes (state, local and miscellaneous federal) were likewise low. At the present time, however, all three of these conditions are reversed, as may be seen from the table below and the diagram on the next page.

Taxes, Net Income and Dividends of All Active Corporations in the U. S.

(In Millions of Dollars)

Year	Net Income before Taxes(a)	Federal Income Taxes	War & Excess Profits Taxes	Local, State & misc. Taxes	Total Taxes	Net Income after Taxes(a)	Dividends Paid(b)
1916	$9,109d	$ 172	$	$1,000	$1,172c	$7,937d	(e)
1917	11,141d	504	1,639	1,041	3,183	7,958d	(e)
1918	8,646	653	2,506	828	3,987	4,659	(e)
1919	9,526	744	1,432	932	3,107	6,419	(e)
1920	7,292	637	989	1,198	2,823	4,469	(e)
1921	2,120	366	335	1,473	2,175	–55	(e)
1922	6,682	775	8	1,518	2,302	4,380	2,634
1923	8,399	937	—	1,635	2,572	5,827	3,299
1924	7,550	882	—	1,670	2,552	4,998	3,424
1925	9,915	1,170	—	1,774c	2,944c	6,971	4,014
1926	9,882	1,230	—	1,878	3,108	6,774	4,439
1927	9,025	1,131	—	2,014	3,145	5,880	4,765
1928	10,953	1,184	—	2,203	3,387	7,566	5,157
1929	11,499	1,193	—	2,222	3,415	8,084	5,927
1930	4,375	712	—	2,297	3,009	1,366	5,631
1931	–515	399	—	2,231	2,630	–3,145	4,182
1932	–3,002	286	—	2,087	2,378	–5,375	2,626
1933	168	416	7	2,124	2,547	–2,379	2,101
1934	2,920	588	8	2,162	2,758	162	2,672
1935	5,037	710	25	2,628	3,363	1,674	2,927
1936	8,052	1,169	22	2,958	4,149	3,903	4,702
1937	8,814	1,233	43	3,666	4,942	3,872	4,832
1938E	6,400	770	30	3,600	4,400	2,000	3,400

Source: Compiled from Statistics of Income, Treasury Department. (a) Includes tax-exempt interest received, but excludes intercorporate dividends received. (b) Cash dividends on preferred and common stock. Excludes stock dividends and intercorporate dividends paid. (c) Partly estimated. (d) Statutory net income; excludes tax-exempt interest received. (e) Not reported. E-Estimated. – Deficit.

Rates of Corporate Income, War and Excess Profits Taxes

Income Year	Income Tax Credit	Income Tax Rate %	War and Excess Profits Taxes Credit	War and Excess Profits Taxes Rate % (e)
1913-15	$	1	$	....
1916	....	2	....	....
1917-a		1 to 4	3,000, plus 7-9% on invested capital	20 to 60
1918-f	2,000	12	3,000, plus 8% on invested capital	30 to 80
1919-21	"	10	"	20 to 40
1922-24	"	12½	....	....
1925	"	13	....	....
1926-27	"	13½	....	....
1928	3,000	12	....	....
1929	"	11	....	....
1930-31	"	12	....	....
1932	......	13¾	....	....
1933-35	......	13¾	12½% on declared capital	5
1936-37-a, b	......	Normal 8 to 15. Und. Inc. 7 to 27.	10% on declared capital	6 to 12
1938-c	......	12½ to 19	"	"
1939-a	......	12½ to 18	"	"
1940-a-d	......	14.85 to 20.9	"	6.6 to 13.2

Source: Compiled from Statistics of Income and Revenue Acts. Because of numerous changes in the detailed provisions of the latter, the rates tabulated above are not strictly comparable. a- Rate of normal tax varies with size of net income. b- Rate of tax on undistributed income varies with percentage of income distributed as dividends. c- Rate of normal tax varies with percentage of income distributed. d- Includes super-tax. e- Rate of tax on excess profits varies, when indicated, with amount of excess over credit, which was computed upon "invested capital" in 1917-1921 but upon "declared value of capital" since 1933. f-Certain corporations were subject to a war-profits tax in 1918.

It will be seen that although the net income before taxes of all corporations in 1937, the latest year for which official figures are available, was about 23 per cent below the 1929 all-time high, the total of corporate taxes in 1937 was the largest ever paid, with the result that net income after taxes in 1937 was less than half that of 1929.

Published reports of leading companies have indicated a sharp decline of earnings in 1938 and a partial recovery in 1939. Even the 1937 figures, however, which (together with 1936) stand around the peak of recovery in corporate earnings from the 1932 depression low, are in striking contrast with those for the three years 1917-19, when the yields of the war excess profits taxes were at their highest.

Although the aggregate net income before taxes of all corporations in 1937, best business year since 1929, was *10 per cent less* than the average of the three years 1917-19, nevertheless the total of corporate taxes was *44 per cent greater*, notwithstanding the inclusion of war-time excess profits taxes in the former period. As a result the net income after taxes in 1937 was *39 per cent less* than the 1917-19 average.

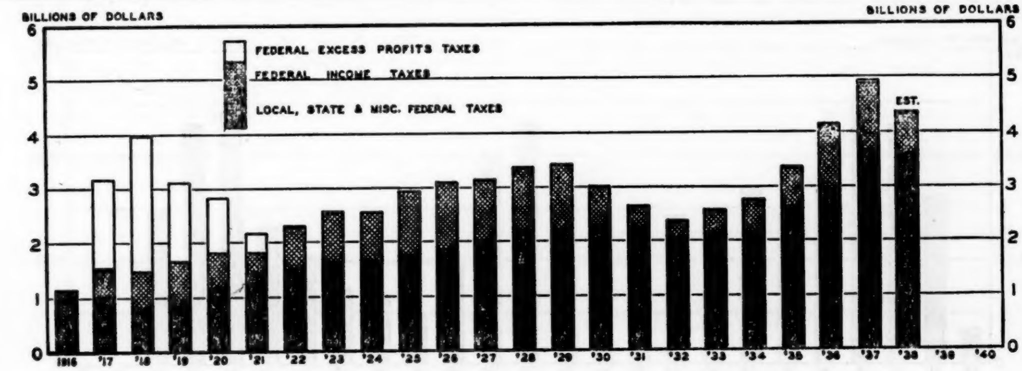
Expressing the figures in another way, the table shows that the portion of corporate income absorbed by taxes rose during the period from 35 to 56 per cent. The relation of total taxes to the net income after taxes available to the corporations and their shareholders rose from 54 per cent to 128 per cent.

Individual Income Taxes Compared

Figures as to the growth of individual taxes are also impressive. Thus, while individual incomes in the best post-depression years — 1936-37 — remained well under the peak years 1918-19 and 1928-29, the taxes paid on these incomes, as shown by the next table and diagram on the following page, remained close to the all-time highs. This, of course, was due to the advance in tax rates, which in 1936-37 were close to the war-time high, and since then have been advanced to levels never before reached.

Federal Individual Income Tax Collections
(In Millions of Dollars)

Year	Amount	Year	Amount	Year	Amount
1916........	$ 173	1924........	$ 704	1932........	$ 330
1917........	795	1925........	735	1933........	374
1918........	1,128	1926........	732	1934........	511
1919........	1,270	1927........	831	1935........	657
1920........	1,075	1928........	1,164	1936........	1,214
1921........	719	1929........	1,002	1937........	1,142
1922........	861	1930........	477	1938........	725
1923........	662	1931........	246		



Taxes Paid by All Active Corporations in the United States

Federal Individual Income Tax Rates

Income Year	Personal Exemptions Single	Personal Exemptions Married	Normal Tax Rate	Surtaxes Begin at	Surtaxes Range of Rates	Maxim. Norm. & Surtax
1913-15....	$3,000	$4,000	1%	$20,000	1-6%	7%
1916..........	3,000	4,000	2	20,000	1-13	15
1917-a......	1,000	2,000	2-4	5,000	1-63+	67+
1918..........	1,000	2,000	6-12	5,000	1-65	77
1919-20....	1,000	2,000	4-8	5,000	1-65	73
1921..........	1,000	2,500	4-8	5,000	1-65	73
1922-23....	1,000	2,500	4-8	6,000	1-50	58
1924..........	1,000	2,500	2-6	10,000	1-40	46
1925-28....	1,500	3,500	1½-5	10,000	1-20	25
1929..........	1,500	3,500	½-4	10,000	1-20	24
1930-31....	1,500	3,500	1½-5	10,000	1-20	25
1932-33....	1,000	2,500	4-8	6,000	1-55	63
1934-35....	1,000	2,500	4	4,000	4-59	63
1936-39....	1,000	2,500	4	4,000	4-75	79
1940	800	2,000	4.4	4,000	4.4-75+	79+

Source: Compiled from Statistics of Income and Revenue Acts. Because of numerous changes in the detailed provisions of the latter, the rates tabulated above are not strictly comparable. a- Certain individuals and partnerships were subject also to an excess profits tax in 1917.

Significance of the Figures

The foregoing does not mean of course that no part of the defense program should be financed by taxes. On the contrary, there are good reasons for believing that Congress was wise in starting the program by raising taxes, and particularly by making more people tax conscious through lowering exemptions and thus widening the tax base. One of the worst consequences of voting huge appropriations without any provision for paying for them is the effect upon the public psychology with respect to the budget. Since no one seems to be paying the deficit billions, the public tends to become indifferent to them, thus discouraging all efforts at economy and leaving the door wide open to more spending and extravagance. Moreover, to the extent that taxes are postponed, borrowing has to be increased, which always carries a threat to confidence and involves passing on more difficult financing and tax problems to the future.

What the figures do mean is that the taxpayers, both individuals and corporations, are already bearing extremely heavy burdens, which should convey a warning as to the dangers of legislation that may add to these burdens in such manner as to actually stop the processes upon which we are dependent for success of the whole plan. Writers upon taxation have frequently stressed the difficulties and injustices involved in excess profits taxes, some of which are suggested in the following extract (recently quoted by the New York Times) from a Senate report of September 26, 1921 on war-time excess profits taxes then in effect:

> The time for discussion (of the excess profits tax) is past; and the time to repeal the tax has arrived. It may be mentioned, however, that further investigation has only accentuated the conviction that the inequalities of this tax make necessary its early repeal. Whatever may be its theoretical merits, in practice it exempts the overcapitalized corporations, falls more heavily upon corporations of small or moderate size than upon the larger corporations, penalizes business conservatism, and places upon the Bureau of Internal Revenue tasks which are beyond its strength.

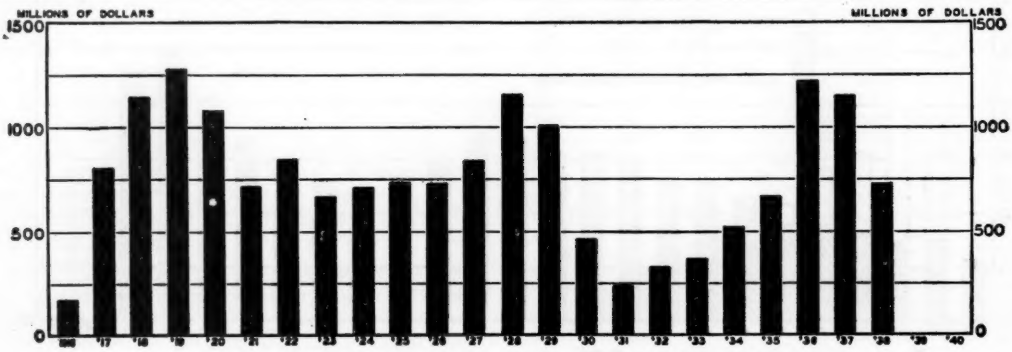
This quotation suggests the kind of difficulties which need careful consideration.

Need for Increased Production

The problem of the defense program centers upon production—or, to put it as simply as possible—upon getting work done. The messages of the President are based upon calculations of man-hours required to equip each branch of the fighting services as planned. The Navy needs battleships, cruisers, auxiliary ships, a fleet of airplanes and a vast amount of other equipment and supplies. The Army needs planes, artillery and guns of all kinds and all the other supplies needed to equip and maintain an army in the field.

The man-hour estimates are converted into dollar estimates and laid before Congress for apportionment of the costs over the whole population. Every man-hour expended in building and supplying the Army and Navy must be reimbursed by the workers on the farms, in the workshops, and business offices, including all professions and employments.

It is evident that the defense program will add enormously to the man-hours of labor ordinarily required in supplying our everyday wants. It should be plain that if the program is to succeed, either the industries must be made more productive or some of the wants



Federal Individual Income Tax Collections in the United States

must be denied, either in whole or in part. It is impossible to consume, or have, more than can be produced. Unless we can produce more, the defense program must be curtailed or the standard of living lowered, and we do not want to do either.

If it be true that the nation must either increase production, lower the standard of living, or abandon the defense program, undoubtedly the people will want to increase production. This can be done in two ways: (1) by putting idle men and idle machines to work and (2) by increasing the productivity of labor and capital already employed.

It was Germany's recognition of the principle of work and production that largely explains her amazing success in the field, while the failure of France was foretold in the following paragraph from the Daladier-Reynaud General Report submitted to the President of France in November, 1938, and quoted two months ago in these columns:

> The gravest failure, from which the others follow, has been the persistently low level of production. * * * If production is insufficient it is primarily because its possibilities of development have been paralyzed. * * * The idea of a reduction in the length of the working day had been entertained on the assumption that, as a result of increased efficiency of labor and more intensive use of machinery, the same output could be obtained with fewer hours of work. But the efficiency of labor has not increased and the hopes founded on technical improvement have not been realized. How could it have been otherwise, when the majority of factories and shops were closed two days out of seven? All the efforts at re-organization that have been tried have failed. Sometimes it has been the authorities themselves who have intervened to prevent the introduction of new methods designed to lower costs. In every field where activity might be reborn enterprise has been restricted and discouraged. The creative spirit and the willingness to take risks have been weakened. This—let us not fear to say it—is the root of the evil, for it adds a sort of moral abdication to the material difficulties.

If it were true that the United States had reached a condition of full employment of men and machines, it is obvious that the possibilities of meeting defense needs out of expanding production would be limited, and the primary problem then would be of curtailing consumption of non-essentials in order to release men and machinery for the supplying of necessary materials for the armed forces. But this is not the condition in the United States today. Though shortages of certain types of labor and manufacturing capacity do indeed exist, by and large we have large reserves of unemployed man-power and capital that can and should be brought into use.

It is against this general background that proposals to further increase the already high level of taxes should be viewed. It may be pointed out that on the basis of present rates the amount of additional revenue that the Government would realize if the economy were operating under full steam would be extremely large. One of the outstanding lessons of the tables and diagrams presented above is the way in which tax collections steadily increased during the 'twenties even though the tax rates were being steadily reduced.

On the other hand, if taxes are advanced too rapidly or at the wrong points there is grave danger that not only will the expansion of the defense industries be impeded but—because of the check upon investment and consumption generally — production, employment and the national income may be frozen at the existing sub-normal levels. In such case all that will have been accomplished will be a shifting of production from peacetime to defense industries and a corresponding reduction in the standard of living.

Only within the past two months we have increased taxes to the extent of approximately a billion dollars a year, and it is conceded that additional taxation may be needed before we are through. But before subjecting industry and the people to new taxes at the risk of impairing efficiency and drying up the sources of capital, we ought to weigh carefully the possibilities that exist not only for increasing tax yields through an expansion of the national income, but also for effecting economies outside of the arms budget. For the past seven years the Federal Government has been spending billions of dollars for pump-priming and relief, justified on the ground that there were not jobs enough to go around and that but for these expenditures millions of people would starve. With so much work now urgently needing to be done for the defense program, it ought to be possible, as the program proceeds, to dispense with most of this "made" work, thus relieving the budget and making available additional funds for arms spending. But here again it is a question of the general policies pursued towards industry. If these are of a kind to encourage and stimulate industry it should be possible to make this shift. Otherwise we are likely to find ourselves saddled with a huge defense cost and a big relief bill besides.

The problem, in other words, is a broad one of making the economy strong as a whole, and of seeking the highest possible productivity of men and machines. Thus the total fund of wealth and income would be increased, and the proportionate burden of defense costs thereby diminished.

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